Table of Contents

inventory in the year ended September 30, 2001, for which there was no comparable charge in the year ended September 30, 2000. The inventory write–down resulted from an unanticipated decline in sales during the year ended September 30, 2001, as well as a high level of inventory and firm inventory commitments compared to our reduced expectations for future product sales. Excluding the inventory write–down, and stock compensation, gross profit decreased to $1.2 million, or 8.6% of net revenues, in the year ended September 30, 2001 from $16.3 million, or 37.9% of net revenues, in the year ended September 30, 2000. This decrease was primarily due to the decrease in product sales volumes and a decrease in license revenues recognized during the year ended September 30, 2001. To a lesser extent, the decrease in gross profit (loss) is the result of a lower average selling price of our products due to competitive pricing pressure in the year ended September 30, 2001.

Operating Expenses

Research and Development. Research and development expenses increased to $12.7 million in the year ended September 30, 2001 from $8.2 million in the year ended September 30, 2000. This increase was due primarily to increased compensation costs as research and development personnel increased from 68 employees at September 30, 2000 to 85 during fiscal 2001 prior to the April and July 2001 restructurings. At September 30, 2001, we had 32 employees in research and development. To a lesser extent, the increase in research and development expenses was due to expenses related to the development of our WebEngine Sierra, StorageArray and ApplianceEngine 1000 products, as well as our StorageEngine Voyager product, which was discontinued in connection with the July 2001 restructuring.

Selling and Marketing. Selling and marketing expenses increased to $18.1 million in the year ended September 30, 2001 from $15.8 million in the year ended September 30, 2000. This increase was due primarily to increased salary costs as a result of the increase in our sales, marketing and customer support personnel to a peak of 98 employees during the year ended September 30, 2001 from 80 employees at September 30, 2000. As of September 30, 2001, we had 23 employees in our sales, marketing and customer support organization. In addition, the increase in selling and marketing expenses is also attributable to increased travel costs as a result of the changes in sales, marketing and customer support personnel during fiscal 2001 and facilities related costs as a result of a full year of expenses associated with the expansion of our Canton headquarters, which occurred during May 2000. These increases were partially offset by decreases in commissions and bonuses as a result of the decrease in revenue during fiscal 2001, recruiting costs and trade show expenses.

General and Administrative. General and administrative expenses increased to $7.0 million in the year ended September 30, 2001 from $4.0 million in the year ended September 30, 2000. This increase was due primarily to an increase in bad debt expense as a result of the general economic slowdown over the past twelve months and the resulting effect that it had on our "new–economy" customers. In addition, the increase in general and administrative expenses is due to increased compensation costs as general and administrative personnel increased from 29 employees at September 30, 2000 to a peak of 34 employees during the year ended September 30, 2001 and ended at 14 employees, as of September 30, 2001. This increase was also due to increased insurance costs associated with our operation as a public company and increased consulting and professional service fees.

Stock Compensation. We recognized stock compensation expense of $3.2 million and $2.9 million in the years ended September 30, 2001 and 2000, respectively, related to the grant of

Table of Contents

options and restricted stock to employees and directors during fiscal 1999 and prior to our initial public offering in fiscal 2000. In connection with restricted stock issued to employees as a result of our acquisition of IP Performance, Inc., we recorded deferred stock compensation of $6.4 million, of which we recognized $2.9 million as stock compensation expense during the year ended September 30, 2001.

Restructuring and Other Charges. During the year ended September 30, 2001, we undertook two restructurings of our operations, the first of these restructurings occurred in April 2001 and the second in July 2001. In the April 2001 restructuring, we sought to better align our operating expenses with reduced revenues, and as a result of the implementation of the restructuring, we recorded a charge to operations of $2.8 million. This charge was due to a reduction in workforce from 243 employees to 170 employees, the curtailment of a planned expansion into leased facilities and other items. This charge included approximately $1.0 million for employee related costs including severance payments to terminated employees and stock option compensation expense related to modifications of certain stock options held by terminated employees, approximately $1.3 million to write off certain assets related to facilities that we did not occupy and approximately $530,000 primarily related to non–refundable deposits on tradeshows we did not attend as well as costs of certain other non–cancellable sales and marketing commitments. The July 2001 restructuring was the result of an intensive review of our business, which resulted in a refocus of the sales strategy toward strategic partnerships with ISVs and OEMs and a discontinuation of much of the customized hardware and software that was previously included in our products. As a result of the implementation of the July 2001 restructuring, we recorded a charge to operations of approximately $6.9 million. This charge included approximately $1.7 million of employee related costs as we reduced our workforce by 65 employees, approximately $2.2 million as a result of the disposal of certain property and equipment, approximately $2.0 million to write off goodwill and intangible assets which were deemed to be impaired, approximately $618,000 of facility costs associated with non–cancelable operating leases for space which will not be occupied and approximately $363,000 of other charges. In addition to the April 2001 and July 2001 restructurings, in March 2001 we recorded a charge due to the retirement of fixed assets related to our WebEngine Blazer product line. These fixed assets had a total net book value of approximately $1.2 million and consisted primarily of computer equipment previously utilized in the production and sales of the WebEngine Blazer, one of our previous generation web content server appliance products. The total of the restructuring and other charges detailed above was approximately $10.9 million recorded for the year ended September 30, 2001. The reduction in our workforce implemented during the year ended September 30, 2001 impacted employees in all of our groups, including manufacturing, research and development, selling and marketing and general and administrative.

Amortization of Goodwill and Intangible Assets. In connection with the acquisition of IP Performance, Inc. in November 2000, we recorded goodwill and intangible assets of $2.7 million, of which we amortized $675,000 in the year ended September 30, 2001. In July 2001, we completed an intensive review of our business, which resulted in the implementation of a restructuring plan. This restructuring plan included a discontinuation of much of the customized hardware and software that had previously been a part of our product development process. As a result of this restructuring and an assessment of expected future cash flows, we determined that the recoverability of intangible assets resulting from our purchase of IP Performance, Inc. was unlikely. We recognized an impairment charge for the full amount of the unamortized intangible assets, approximately $2.0 million, during the fourth quarter of fiscal 2001.

Table of Contents

Interest and Other Income (Expense), net

Interest and other income (expense) net increased to $5.2 million in the year ended September 30, 2001 from $2.0 million in the year ended September 30, 2000. This increase was due to a higher average cash balance as a result of the investment of the net proceeds of our initial public offering in July 2000.

Liquidity and Capital Resources

Since fiscal 1997, we have financed our operations primarily through the sale of equity securities, borrowings and the sale of our products. On July 18, 2000, we completed our initial public offering by selling 7,475,000 shares of common stock, including the exercise of the underwriters' over–allotment option of 975,000 shares, at $17 per share and raised approximately $116.9 million, net of offering costs and underwriting fees totaling approximately $10.2 million. Prior to the initial public offering, we raised approximately $37.3 million, net of offering costs, from the issuance of preferred stock. As of September 30, 2002, we had $55.1 million in cash, cash equivalents and short–term investments, excluding restricted cash of $1.1 million.

Cash used in operating activities was $23.7 million, $32.9 million and $15.7 million in the years ended September 30, 2000, 2001 and 2002, respectively. Cash used in operating activities in fiscal 2000 was primarily due to a net loss of $12.5 million and increases in accounts receivable, the amount due from our contract manufacturer and inventories offset in part by increases in accounts payable, accrued expenses and deferred revenue and adjusted for non–cash charges for stock compensation, depreciation and inventory reserves. Cash used in operating activities in fiscal 2001 was primarily due to a net loss of $69.5 million, an increase in inventories and prepaid expenses and other current assets and decreases in accounts payable and deferred revenue. These uses of cash were offset in part by a decrease in accounts receivable and a net increase in the amount due to our contract manufacturer and adjustments for non–cash charges for inventory reserves, restructuring and other charges, stock compensation and depreciation and amortization. Cash used in operations in fiscal 2002 was primarily due to a net loss of $14.1 million, increases in accounts receivable and inventories and decreases in the amount due to our contract manufacturer and accrued expenses. These uses of cash were offset in part by non–cash adjustments for stock compensation and depreciation.

Cash used in investing activities was $7.8 million, $4.2 million and $8.6 million in fiscal 2000, 2001 and 2002, respectively. Cash used in investing activities in fiscal 2000 was primarily for purchases of property and equipment and leasehold improvements to our facility in Canton, Massachusetts. Cash used in investing activities during fiscal 2001 was primarily for purchases of property and equipment and also included deposits of restricted cash for an executive loan guarantee. Cash used in investing activities in fiscal 2002 was primarily for purchases of short–term investments.

Cash provided by (used in) financing activities was $142.4 million, ($383,000) and ($3.9) million in fiscal 2000, 2001 and 2002, respectively. In fiscal 2000, cash provided by financing activities was primarily generated through our initial public offering of common stock and from the sale of preferred stock through which we raised net proceeds of approximately $116.9 million and $25.2 million, respectively. Cash used in financing activities in fiscal 2001 was primarily through the issuance of notes to stockholders and the acquisition of treasury stock, offset in part by cash provided by the

Table of Contents

issuance of common stock from the exercise of stock options and through our employee stock purchase plan. Cash used in financing activities in fiscal 2002 was primarily for repurchases of common stock under our $5.0 million stock repurchase program.

In August 2001, the board of directors authorized the repurchase of up to $5.0 million of our common stock from time to time on the open market or in non--solicited privately negotiated transactions. In November 2002, we completed the stock repurchase program. Through the end of this program, we repurchased approximately 4,594,000 shares of common stock for approximately $4.6 million of cash and repurchased approximately 589,000 shares of common stock in exchange for the retirement of approximately $411,000 of stockholder notes receivable.

As a result of the fiscal 2001 and 2002 restructurings, we are obligated to make additional cash payments of approximately $355,000 over the next twelve months. We anticipate that funds required to make all restructuring payments will be available from our current working capital. We believe that the restructuring actions undertaken during fiscal 2002 will result in cost savings of approximately $1.3 million during fiscal 2003.

On January 9, 2001, we deposited $1.1 million of cash with a bank to guarantee a personal loan of Lawrence A. Genovesi, our current Chairman and former President, Chief Executive Office and Chief Technology Officer. The guarantee period, as amended, ends on January 9, 2003, at which time the balance of the amount deposited with the bank, which is not required to satisfy any obligations under the guarantee, will be returned to us. The bank may draw down against this deposited amount in the event that Mr. Genovesi does not make required payments as due under the personal loan agreement. In conjunction with our guarantee of this loan, we entered into a pledge agreement with Mr. Genovesi whereby he pledged to us, as collateral, all shares of our common stock currently held by him, all shares of our common stock acquired by him at any future time and a second mortgage on certain real property owned by Mr. Genovesi.

During fiscal year 2002, we repurchased 328,572 shares of common stock held by Mr. Genovesi at a cost of $248,000. Of the purchase price, $203,000 was applied against Mr. Genovesi's outstanding loans due to us, while the remaining $45,000 was paid in cash to Mr. Genovesi. Mr. Genovesi also repaid $15,000 due to us under his remaining outstanding loans.

In April 2001, we entered into five recourse loans with certain of our officers and employees at that time totaling approximately $508,000. We entered into these loan agreements to avoid substantial sales of our common stock by these individuals as a result of their alternative minimum tax obligations incurred as a result of their exercise of common stock options. The loans bear interest at 4.63% per year and were due, as amended, in September 2002. These officers and employees pledged to us all shares of our common stock owned by them, all common stock options held by them and all proceeds received by them on the sale of either our common stock or common stock options. During fiscal year 2002, we received proceeds from loans principal and interest payments of approximately $30,000; we repurchased 260,777 shares of common stock as repayment for principal and interest for an additional $267,000. As a result, the outstanding principal and accrued interest related to these notes was $255,000 at September 30, 2002. The remaining loans are in default and we have sent demand notices to the holders, one of which is a former officer and the other is a former employee. We expect to recover any amounts not paid in cash through the reacquisition of common stock.

Table of Contents

The following table sets forth future payments that we are obligated to make under capital and operating lease commitments as of September 30, 2002 (in thousands):

Contractual obligations	2003	2004	2005	Total
Operating leases	$ 892	$ 916	$ 356	$ 2,164
Capital leases	14	—	—	14
Total contractual cash obligations	$ 906	$ 916	$ 356	$ 2,178

On November 11, 2002, we entered into an agreement to acquire all the outstanding common stock of TidalWire, Inc. ("TidalWire"). The purchase consideration will include a net cash payment of approximately $8,805,000, representing gross cash payments of $9,350,000 less repayment of stockholder notes receivable of approximately $545,000, the issuance of approximately 3,331,000 shares of our common stock, the replacement of outstanding TidalWire common stock options with options to purchase approximately 1,669,000 shares of our common stock with an average exercise price of $0.36 per share and the assumption of all amounts outstanding under TidalWire's $5,000,000 working capital line of credit (approximately $2.7 million at October 31, 2002). Pending approval of this acquisition by both our stockholders and TidalWire's stockholders, we expect to close this acquisition at the end of December 2002. In connection with this acquisition, we estimate that we will incur transaction–related expenses of approximately $1,900,000. The amount of cash paid by us to the stockholders of TidalWire may be adjusted based upon TidalWire's working capital as of the closing of the merger or if TidalWire's transaction costs exceed $650,000.

Our future liquidity and capital requirements will depend upon numerous factors, including:

our ability to form an adequate number of strategic partnerships with ISVs and OEMs;

the level of success of our strategic ISV and OEM partners in selling server appliance solutions that include our server appliance hardware platforms;

the costs associated with any merger and acquisition activities;

the costs and timing of product engineering efforts and the success of these efforts;

the costs involved in obtaining, maintaining and enforcing intellectual property rights; and

market developments.

We believe that our available cash resources, including cash, cash equivalents and short–term investments, together with cash we expect to generate from sales of our products will be sufficient to meet our operating and capital requirements through at least the next twelve months. After that, we may need to raise additional funds. We may seek to raise additional funds through borrowings, public or private equity financings or from other sources. There can be no assurance that additional financing will be available at all or, if available, will be on terms acceptable to us. If additional financing is needed and is not available on acceptable terms, we may need to reduce our operating expenses.

Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141 ("SFAS 141"), "Business Combinations" and SFAS No. 142 ("SFAS 142"), "Goodwill and Other

Table of Contents

Intangible Assets." SFAS 141 requires that all business combinations be accounted for under the purchase method only and that certain acquired intangible assets in a business combination be recognized as assets apart from goodwill. SFAS 142 requires, among other things, the cessation of the amortization of goodwill. In addition, SFAS 142 includes provisions for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the identification of reporting units for purposes of assessing potential future impairments of goodwill. SFAS 142 also requires the completion of a transitional goodwill impairment test six months from the date of adoption. SFAS 141 is effective for all business combinations initiated after June 30, 2001. SFAS 142 is effective for our fiscal year beginning on October 1, 2002. We do not expect the adoption of SFAS 142 to have a material impact on our financial position or results of operations.

In October 2001, the FASB issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long–Lived Assets" ("SFAS 144"). The objectives of SFAS 144 are to address significant issues relating to the implementation of FASB Statement No. 121, "Accounting for the Impairment of Long–Lived Assets and for Long–Lived Assets to Be Disposed Of" ("SFAS 121"), and to develop a single accounting model, based on the framework established in SFAS 121, for long–lived assets to be disposed of by sale, whether previously held and used or newly acquired. SFAS 144 supersedes SFAS 121; however, it retains the fundamental provisions of SFAS 121 for (1) the recognition and measurement of the impairment of long–lived assets to be held and used and (2) the measurement of long–lived assets to be disposed of by sale. SFAS 144 supersedes the accounting and reporting provisions of Accounting Principles Board No. 30, "Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions" ("APB 30"), for segments of a business to be disposed of. However, SFAS 144 retains APB 30's requirement that entities report discontinued operations separately from continuing operations and extends that reporting requirement to "a component of an entity" that either has been disposed of or is classified as "held for sale." SFAS 144 also amends the guidance of Accounting Research Bulletin No. 51, "Consolidated Financial Statements," to eliminate the exception to consolidation for a temporarily controlled subsidiary. SFAS 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001, including interim periods, and, generally, its provisions are to be applied prospectively. We do not expect the adoption of SFAS 144 to have a material impact on our financial position or results of operations.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" ("SFAS 146"). This statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF Issue No. 94–3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)" ("EITF 94–3"). SFAS 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. EITF 94–3 allowed for an exit cost liability to be recognized at the date of an entity's commitment to an exit plan. SFAS 146 also requires that liabilities recorded in connection with exit plans be initially measured at fair value. The provisions of SFAS 146 are effective for exit or disposal activities that are initiated after December 31, 2002, with early adoption encouraged. We do not expect the adoption of SFAS 146 to have a material impact on our financial position or results of operations.

Table of Contents

In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34" ("FIN 45"). FIN 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN 45 does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee. It also incorporates, without change, the guidance in FASB Interpretation No. 34, "Disclosure of Indirect Guarantees of Indebtedness of Others," which is being superseded. The disclosure provisions of FIN 45 are effective for financial statements of interim or annual periods that end after December 15, 2002 and the provisions for initial recognition and measurement are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002, irrespective of a guarantor's year–end. We are currently assessing the impact of the adoption of FIN 45 on our financial position and results of operations.

FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS

The risks and uncertainties described below are not the only ones we are faced with. Additional risks and uncertainties not presently known to us, or that are currently deemed immaterial, may also impair our business operations. If any of the following risks actually occur, our financial condition and operating results could be materially adversely affected.

Risk related to revenue concentration.

We derive a substantial portion of our revenues from one OEM customer, and our revenues may decline significantly if this customer cancels or delays purchases of our products, terminates their contract with us, or exercises certain of their other rights under the terms of the contract.

In the year ended September 30, 2002, one customer accounted for 83% of our net revenues. Under the terms of our non–exclusive contract with this customer, the customer has the right to enter into agreements with other parties for similar products, the customer is not obligated to purchase any minimum quantity of products from us and the customer may choose to stop purchasing from us at any time. In addition, the customer may terminate the agreement in the event that we attempt to assign its rights under the agreement to another party without the customer's prior approval. Furthermore, in the event that we default on certain portions of the agreement and do not cure during the prescribed cure period, the customer may obtain the right to manufacture the products defined in the agreement in exchange for a mutually agreeable royalty fee. If any of these events were to occur, or if this customer delays purchases of our products, our revenues and operating results would be adversely affected, our reputation in the industry may suffer and our ability to predict cash flow accurately would decrease. Accordingly, unless and until we expand and diversify our revenue base, our future success will depend upon the timing and size of future purchase orders, if any, from this customer.

Table of Contents

Risks related to business strategy.

If we fail to form a significant enough number of strategic partnerships with independent software vendors and original equipment manufacturers, we may be unable to generate significant sustainable revenues and our operations could be materially adversely affected and, as a result, we may choose to discontinue one or more of the components of our business strategy.

A major component of our business strategy is to focus our sales and marketing efforts on indirect sales through strategic partnerships with ISVs and OEMs. To date, we have not entered into a significant number of definitive agreements with ISVs and OEMs. We may not be able to develop a significant number of strategic partnerships with ISVs and OEMs and, even if we are successful in developing strategic partnerships with ISVs and OEMs, this strategy may fail to generate sufficient revenues to offset the demands that this strategy will place on our business. A failure to generate significant revenues from strategic partnerships could materially adversely affect our operations and, as a result, we may choose to discontinue one or more of the components of our business strategy.

We changed our product strategy during fiscal 2001. There can be no assurance that the change in our product strategy will have the intended effect on our business.

Our product strategy is to concentrate resources on our core competencies, which we believe to be hardware platform packaging and the ability to integrate hardware platforms with various operating systems, management systems and application software systems. This strategy includes a transformation of our product development process from one requiring significant proprietary hardware development to one utilizing standard hardware. There can be no assurance that our product strategy will have a positive effect on operations, market share, the market price of our common stock or public perception of us in the server appliance marketplace, or that we will ever achieve substantial revenues or profitability.

Risks related to the server appliance market.

If server appliances are not increasingly adopted as a solution to meet companies' computer application needs, the market for our products may not grow and the market price of our common stock could decline as a result of lower revenues or reduced investor expectations.

We expect that substantially all of our revenues will come from sales of server appliance platforms and customized integration services. As a result, we depend on the growing use of server appliances to meet businesses' computer application needs. The market for server appliance products has only recently begun to develop and we believe it is evolving rapidly. Because this market is new, we cannot predict its potential size or future growth rate with a high degree of certainty. Our revenues may not grow and the market price of our common stock could decline if the server appliance market does not grow rapidly.

We believe that our expectations for the growth of the server appliance market may not be fulfilled if customers continue to use general–purpose servers. The role of our products could, for example, be limited if general–purpose servers become better at performing functions currently being performed by server appliances or are offered at a lower cost. This could force us to further lower the prices of our products or result in fewer sales of our products.

Table of Contents

Server appliance products are subject to rapid technological change due to changing operating system software and network hardware and software configurations, and our sales will suffer if our products are rendered obsolete by new technologies.

The server appliance market is characterized by rapid technological change, frequent new product introductions and enhancements, potentially short product life cycles, changes in customer demands and evolving industry standards. Our products could be rendered obsolete if products based on new technologies are introduced or new industry standards emerge.

Our future success depends upon our ability to utilize our creative packaging and hardware and software integration skills to combine industry–standard hardware and software to produce low–cost, high–performance products that satisfy our strategic partners' requirements and achieve market acceptance. We cannot be certain that we will successfully identify new product opportunities and develop and bring new products to market in a timely and cost–effective manner.

Risks related to competition.

If we are not able to effectively compete against providers of general–purpose servers, specific–purpose servers or other server appliance providers, our revenues will not increase and may decrease.

In the server appliance market, we face significant competition from a number of different types of companies. Our competitors include companies who market general–purpose servers, specific–purpose servers and server appliances as well as companies that sell custom integration services utilizing hardware produced by other companies. Many of these companies are larger than us and have greater financial resources and name recognition than us as well as significant distribution capabilities and larger, more established service organizations to support their products. Our large competitors may be able to leverage their existing resources, including their extensive distribution capabilities and their service organizations, to provide a wider offering of products and services as well as higher levels of support on a more cost–effective basis than we can. In addition, competing companies may be able to undertake more extensive promotional activities, adopt more aggressive pricing policies and offer more attractive terms to their customers than we can. If our competitors provide lower cost solutions with greater functionality or support than our products, or if some of their products are comparable to ours and are offered as part of a range of products that is broader than ours, our products could become undesirable. Even if the functionality of competing products is equivalent to ours, we face a substantial risk that a significant number of customers would elect to pay a premium for similar functionality rather than purchase products from a less–established vendor. We attempt to differentiate ourselves from our competition by offering a wide variety of software integration, branding, supply–chain management and fulfillment services. If we are unable to effectively differentiate our products from those of our competition, our revenues will not increase and may decline. Furthermore, increased competition could negatively affect our business and future operating results by leading to price reductions, higher selling expenses or a reduction in our market share.

Our revenues could be negatively affected if our larger competitors make acquisitions in order to join their extensive distribution capabilities with our smaller competitors' products.

Large server manufacturers may not only develop their own server appliance solutions, but they may also acquire or establish cooperative relationships with our smaller competitors, including smaller

Table of Contents

private companies. Because large server manufacturers have significant financial and organizational resources available, they may be able to quickly penetrate the server appliance market by leveraging the technology and expertise of smaller companies and utilizing their own extensive distribution channels. We expect that the server industry will experience further consolidation. It is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share through consolidation. Consolidation within the server marketplace could adversely affect our revenues.

We may sell fewer products if other vendors' products are no longer compatible with our products or other vendors bundle their products with those of our competitors and sell them at lower prices.

Our ability to sell our products depends in part on the compatibility of our products with other vendors' software and hardware products. Developers of these products may change their products so that they will no longer be compatible with our products. These other vendors may also decide to bundle their products with other server appliances for promotional purposes and discount the sales price of the bundle. If that were to happen, our business and future operating results could suffer if we were no longer able to offer commercially viable products.

Risks related to financial results.

We have a history of losses and expect to experience losses in the future, which could result in the market price of our common stock declining further.

Since our inception, we have incurred significant net losses, including net losses of $12.5 million, $69.5 million and $14.1 million in fiscal 2000, 2001 and 2002, respectively. We expect to continue to have net losses in the future. In addition, we had an accumulated deficit of $107.6 million as of September 30, 2002. We believe that any future growth will require us to incur significant engineering, selling and marketing and administrative expenses. As a result, we will need to generate significant revenues to achieve profitability. We cannot be certain that we will achieve profitability in the future or, if we achieve profitability, that we will be able to sustain it. If we do not achieve and maintain profitability, the market price for our common stock may decline.

Our quarterly revenues and operating results may fluctuate due to the timing and size of orders from customers, a lack of growth of the server appliance market in general or the failure of our products to achieve market acceptance.

Our quarterly revenues and operating results are difficult to predict and may fluctuate significantly from quarter to quarter due to the timing and size of orders from customers, particularly our largest OEM, and because server appliances generally, and our current products in particular, are relatively new and the future growth of the market for our products is uncertain. We also expect to rely on additional new products for growth in our net revenues in the future. In addition, none of our customers are obligated to purchase any quantity of our products in the future. If the timing or size of orders from customers, particularly our largest OEM, differs from expectations, the server appliance market in general fails to grow as expected or our products fail to achieve market acceptance, our quarterly net revenues and operating results may fall below the expectations of investors and public market research analysts. In this event, the market price for our common stock could decline.

Table of Contents

If the commoditization of products and competition in the server appliance market increases, then our gross profit as a percentage of net revenues may decrease and our operating results may suffer.

Products and services in the server appliance market may be subject to further commoditization as the industry matures and other businesses introduce more competing products and services. The gross margin as a percentage of revenues of our products is already low, and may not grow to our targeted gross margin percentages or may even decrease, in response to changes in our product mix, competitive pricing pressures, or new product introductions into the server appliance marketplace. If we are unable to offset decreases in our gross margins as a percentage of revenues by increasing our sales volumes, operating results will decline. Changes in the mix of sales of our products, including the mix of higher margin sales of products sold in smaller quantities and somewhat lower margin sales of products sold in larger quantities, could adversely affect our operating results for future quarters. To maintain our gross margins, we also must continue to reduce the manufacturing cost of our products. Our efforts to produce higher margin products, continue to improve our products and produce new products may make it difficult to reduce our manufacturing cost per product. Further, utilization of a contract manufacturer may not allow us to reduce our cost per product.

Risks related to marketing and sales efforts.

We need to effectively manage our sales and marketing operations to increase market awareness and sales of our products. If we fail to do so, our growth, if any, will be limited.

During April and July 2001, we significantly reduced our selling and marketing personnel in an attempt to reduce operating expenses and to conserve cash. Although we have fewer selling and marketing personnel, we must continue to increase market awareness and sales of our products. If we fail in this endeavor, our growth, if any, will be limited.

Efforts to promote our brand may not result in the desired brand recognition by existing or potential ISV and OEM customers or in increased sales.

In the fast growing market for server appliance solutions, we believe that we need a strong brand to compete successfully. In order to attract and retain ISV and OEM customers, we believe that the Network Engines brand must be recognized and viewed favorably by ISVs and OEMs. During fiscal 2001, we reduced our marketing programs. If we are unable to design and implement effective marketing campaigns or otherwise fail to promote and maintain the Network Engines brand, sales may not increase and our business may be adversely affected. Our business may also suffer if we incur excessive expenses promoting and maintaining the Network Engines brand but fail to achieve the expected or desired increase in revenues.

If we are unable to effectively manage our customer service and support activities, we may not be able to retain our existing ISV and OEM customers and attract new ISV and OEM customers.

We have a small customer service and support organization. We need to effectively manage our customer support operations to ensure that we maintain good relationships with our customers. If our customer support organization is unsuccessful in maintaining good customer relationships, we may lose customers to our competitors and our reputation in the market could be damaged. As a result, we may lose revenue and incur losses greater than expected.

Table of Contents

Risks related to product manufacturing.

If we do not accurately forecast our component requirements, our business and operating results could be adversely affected.

We use rolling forecasts based on anticipated product orders to determine our component requirements. Lead times for materials and components that we order vary significantly and depend on factors including specific supplier requirements, contract terms and current market demand for those components. In addition, a variety of factors, including the timing of product releases, potential delays or cancellations of orders and the timing of large orders, make it difficult to predict product orders. As a result, our component requirement forecasts may not be accurate. If we overestimate our component requirements, we may have excess inventory, which would increase costs and negatively impact our cash position. If we underestimate our component requirements, we may have inadequate inventory, which could interrupt our manufacturing and delay delivery of our products to customers. Any of these occurrences would negatively impact our business and operating results.

Our dependence on sole source and limited source suppliers for key components makes us susceptible to supply shortages that could prevent us from shipping customer orders on time, if at all, and could result in lost sales or customers.

We depend upon single source and limited source suppliers for our industry–standard processors, main logic boards, certain disk drives, and power supplies as well as our internally developed heat–pipe, chassis and sheet metal parts. We also depend on limited sources to supply several other industry–standard components. We have in the past experienced, and may in the future experience, shortages of or difficulties in acquiring components needed to produce our products. Shortages have been of limited duration and have not yet caused material delays in production of our products. However, shortages in supply of these key components for an extended time would cause delays in the production of our products, prevent us from satisfying our contractual obligations and meeting customer expectations, and result in lost sales or customers. If we are unable to buy components that we need or if we are unable to buy components at acceptable prices, we will not be able to manufacture and deliver our products on a timely or cost–effective basis to our customers.

Our future success is dependent on our ability to expand production capacity.

Our existing manufacturing facility is limited in its production capacity. For us to be successful our product sales volumes must increase significantly. Our production capacity must increase to support significant increases in product sales volumes. In order to increase our production capacity, we may have to utilize the services of a contract manufacturer to produce our products at high volumes. We may have difficulties in identifying and engaging a contract manufacturer to produce our products with terms that are favorable to us. Using a contract manufacturer may increase the cost of producing products and we could experience transitional difficulties including production delays and quality control issues, which could cause customer relationships to suffer and result in lost sales. Also, the use of a contract manufacturer may not guarantee us production levels, manufacturing line space or manufacturing prices, which could interrupt our business operations and have a negative effect on operating results.

Table of Contents

Risks related to product dependence on intellectual property and use of the Network Engines brand.

Our reliance upon contractual provisions, domestic patent, copyright and trademark laws and applied–for patents to protect our proprietary rights may not be sufficient to protect our intellectual property from others who may sell similar products.

Certain of our products are differentiated from those of our competitors by our internally developed software and hardware and the manner in which they are integrated into our products. If we fail to protect our intellectual property, other vendors could sell products with features similar to ours, and this could reduce demand for our products. We believe that the steps we have taken to safeguard our intellectual property afford only limited protection. Others may develop technologies that are similar or superior to our technology or design around the copyrights and trade secrets we own. Despite the precautions we have taken, laws and contractual restrictions may not be sufficient to prevent misappropriation of our technology or deter others from developing similar technologies. In addition, there can be no guarantee that any of our patent applications will result in patents, or that any such patents would provide effective protection of our technology.

In addition, the laws of the countries in which we decide to market our services and solutions may offer little or no effective protection of our proprietary technology. Reverse engineering, unauthorized copying or other misappropriation of our proprietary technology could enable third–parties to benefit from our technology without paying us for it, which would significantly harm our business.

We have invested substantial resources in developing our products and the Network Engines brand, and our operating results would suffer if we were subject to a protracted infringement claim or one that resulted in a significant damages award.

Substantial litigation regarding intellectual property rights and brand names exists in our industry. We expect that server appliance products may be increasingly subject to third–party infringement claims as the number of competitors in the industry segment grows and the functionality of products in different industry segments overlaps. From time to time we receive claims from third parties that our products have infringed their intellectual property rights. We do not believe that our products employ technology that infringes any proprietary rights of third parties. However, third parties may make claims that we have infringed upon their proprietary rights. Any claims, with or without merit, could:

- be time–consuming to defend;
- result in costly litigation, including potential liability for damages;
- divert our management's attention and resources;
- cause product shipment delays; or
- require us to enter into royalty or licensing agreements.

Royalty or licensing agreements may not be available on terms acceptable to us, if at all. A successful claim of product infringement against us or the failure or inability to license the infringed or similar technology could adversely affect our business because we would not be able to sell the impacted product without redeveloping it or incurring significant additional expenses.

Table of Contents

Risks relating to our pending acquisition of TidalWire, Inc.

Failure to complete the acquisition could negatively impact the market price of our common stock and our future business and operations.

Our acquisition of TidalWire is subject to certain closing conditions, including the approval of the stockholders of each of Network Engines and TidalWire and other customary closing conditions. If we do not complete the acquisition for any reason, we will be subject to a number of risks, including:

- the market price of our common stock could decline to the extent that the current market price reflects a market assumption that the acquisition will be completed;
- our costs related to the merger, such as legal, accounting and investment banking fees, must be paid even if the acquisition is not completed; and
- benefits we expect to realize from the acquisition would not be realized.

We may not be able to successfully integrate TidalWire into our operations.

The integration of TidalWire into our operations involves a number of risks, including:

- difficulty integrating TidalWire's operations and personnel;
- diversion of management attention;
- potential disruption of ongoing business;
- inability to retain key personnel;
- inability to successfully incorporate TidalWire's products and services into our product and service offerings and to develop new products and services; and
- impairment of relationships with employees, customers or vendors.

Combined company will have increased dependence on a strategic partner.

We derive a substantial portion of our revenue from one OEM customer. TidalWire relies on reference sales originating from that same OEM for a significant amount of its revenue. Although TidalWire does not sell a significant amount of products directly to the OEM, it is one of two North American distributors that this OEM refers its customers to for the supply of data storage network components that have been authorized for use in this OEM's data storage networks. Because of this relationship, TidalWire receives favorable pricing from the suppliers of these authorized data storage components and is able to realize higher gross margins on the sale of this product. The products that we sell to the OEM and the data storage components that TidalWire distributes to resellers and other customers are unrelated and mutually exclusive of each other. If the merger is consummated, the combined company will depend on this OEM to an even greater extent.

If this OEM partner were to discontinue purchasing Network Engines' products from the combined company or stop referring its customers to the combined company for authorized data storage components, or introduce more authorized distributors for the data storage components that TidalWire distributes, then the combined company's revenues and operating results would be adversely affected.

Table of Contents

Other risks related to our business.

A class action lawsuit has been filed against us, our chairman and one of our executive officers.

On or about December 3, 2001, a class action lawsuit was filed against us, our chairman, one of our executive officers and the underwriters of our initial public offering. We are unable to predict the effects of this suit, or other similar suits, on our financial condition and business and, although we maintain certain insurance coverage, there can be no assurance that this claim will not result in substantial monetary damages in excess of such insurance coverage. In addition, we may expend significant resources to defend this case. This class action lawsuit, or other similar suits, could negatively impact both our financial condition and the market price of our common stock.

If the market price of our common stock is not quoted on a national exchange, our ability to raise future capital may be hindered and the market price of our common stock may be negatively impacted.

The market price of our common stock has declined since our fiscal year 2000 and at times has been less than $1.00 per share. If we are unable to meet the stock price listing requirements of NASDAQ, our common stock could be de–listed from the NASDAQ National Market. If our common stock were de–listed from the NASDAQ National Market, among other things, this could result in a number of negative implications, including reduced liquidity in our common stock as a result of the loss of market efficiencies associated with NASDAQ and the loss of federal preemption of state securities laws as well as the potential loss of confidence by suppliers, customers and employees, the loss of analyst coverage and institutional investor interest, fewer business development opportunities and greater difficulty in obtaining financing.

If our products fail to perform properly and conform to specifications, our customers may demand refunds or assert claims for damages and our reputation and operating results may suffer.

Because our server appliance hardware platforms are complex, they could contain errors that can be detected at any point in a product's life cycle. In the past we have discovered errors in some of our products and have experienced delays in the shipment of our products during the period required to correct these errors or we have had to replace defective products that were already shipped. These delays and replacements have principally related to new product releases. Errors in our products may be found in the future and any of these errors could be significant. Detection of any significant errors may result in:

- the loss of or delay in market acceptance and sales of our products;
- diversion of engineering resources;
- injury to our reputation; or
- increased maintenance and warranty costs.

These problems could harm our business and future operating results. Product errors or delays could be material, including any product errors or delays associated with the introduction of new products or the versions of our products that support Windows or UNIX–based operating systems.

Table of Contents

While we attempt to limit our risk contractually, if our products fail to conform to warranted specifications, customers could demand a refund for the purchase price or assert claims for damages.

Moreover, because our products may be used in connection with critical computing systems services, we may receive significant liability claims if our products do not work properly. Our agreements with customers typically contain provisions intended to limit our exposure to liability claims. However, these limitations may not preclude all potential claims. Liability claims could exceed our insurance coverage and require us to spend significant time and money in litigation or to pay significant damages. Any claims for damages, even if unsuccessful, could seriously damage our reputation and business.

If we fail to retain appropriate levels of qualified technical personnel, we may not be able to develop and introduce our products on a timely basis.

We require the services of qualified technical personnel. We have experienced the negative effects of an economic slowdown. Our revenues have declined significantly since our fiscal year ended September 30, 2000 and the market price of our common stock has decreased significantly. As a result, we have implemented various personnel reductions, which have placed added pressure on the remaining employees and management. These and other factors may make it difficult for us to retain the qualified employees and management that we need to effectively manage our business operations, including key engineering activities. If we are unable to retain a sufficient number of technical personnel we may not be able to complete development of, or upgrade or enhance, our products in a timely manner or successfully integrate our ISV Partners' software with our hardware platforms, which could negatively impact our business and could hinder any future growth.

Our stock may be subject to substantial price and volume fluctuations due to a number of factors, many of which will be beyond our control that may prevent our stockholders from reselling our common stock at a profit.

The securities markets have experienced significant price and volume fluctuations in the past and the market prices of the securities of technology companies have been especially volatile. This market volatility, as well as general economic, market or political conditions, could reduce the market price of our common stock in spite of our operating performance. In addition, our operating results could be below the expectations of public market analysts and investors, and in response, the market price of our common stock could decrease significantly. Investors may be unable to resell their shares of our common stock for a profit. In the past, companies that have experienced volatility in the market price of their stock have been the object of securities class action litigation. If we were the object of securities class action litigation, it could result in substantial costs and a diversion of management's attention and resources. The decline in the market price of our common stock and market conditions generally could adversely affect our ability to raise additional capital, to complete future acquisitions of or investments in other businesses and to attract and retain qualified technical and sales and marketing personnel.

Future sales by existing stockholders could depress the market price of our common stock.

Sales of a substantial number of shares of our common stock by existing stockholders could depress the market price of our common stock and impair our ability to raise capital through the sale of additional equity securities.

Table of Contents

We have anti–takeover defenses that could delay or prevent an acquisition and could adversely affect the price of our common stock.

Our board of directors has the authority to issue up to 5,000,000 shares of preferred stock and, without any further vote or action on the part of the stockholders, will have the authority to determine the price, rights, preferences, privileges and restrictions of the preferred stock. This preferred stock, if issued, might have preference over the rights of the holders of common stock and could adversely affect the price of our common stock. The issuance of this preferred stock may make it more difficult for a third party to acquire us or to acquire a majority of our outstanding voting stock. We currently have no plans to issue preferred stock.

In addition, provisions of our second amended and restated certificate of incorporation, second amended and restated by–laws and equity compensation plans may deter an unsolicited offer to purchase us. These provisions, coupled with the provisions of the Delaware General Corporation Law, may delay or impede a merger, tender offer or proxy contest involving us. For example, our board of directors is divided into three classes, only one of which is elected at each annual meeting. These factors may further delay or prevent a change of control of our business.

If we do not retain our senior management, we may not be able to successfully execute our business plan.

As a result of past restructurings, we have lost members of our management team. The loss of key members of our current management team could harm us. Our success is substantially dependent on the ability, experience and performance of our senior management team. Because of their ability and experience, we may not be able to implement successfully our business strategy if we were to lose one or more of these individuals.

We may need additional capital that may not be available to us and, if raised, may dilute our existing investors' ownership interests.

We may need to raise additional funds to develop or enhance our services and solutions, to fund expansion, to respond to competitive pressures or to acquire complementary products, businesses or technologies. Additional financing may not be available on terms that are acceptable to us. If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders would be reduced and these securities might have rights, preferences and privileges senior to those of our current stockholders. If adequate funds are not available on acceptable terms, our ability to fund expansion, take advantage of unanticipated opportunities, develop or enhance products or services, or otherwise respond to competitive pressures would be significantly limited.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not engage in any foreign currency hedging transactions and therefore, do not believe we are subject to exchange rate risk. We are exposed to market risk related to changes in interest rates. We invest excess cash balances in cash equivalents. We believe that the effect, if any, of reasonably possible near–term changes in interest rates on our financial position, results of operations and cash flows will not be material.

Table of Contents

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Table of Contents

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Stockholders
of Network Engines, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of stockholders' equity (deficit) and of cash flows present fairly, in all material respects, the financial position of Network Engines, Inc. and its subsidiaries at September 30, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2002 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/S/ PRICEWATERHOUSECOOPERS LLP

Boston, Massachusetts
November 5, 2002, except for Note 16
for which the date is December 20, 2002

Table of Contents

NETWORK ENGINES, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

	September 30, 2001	September 30, 2002
ASSETS		
Current assets:		
Cash and cash equivalents	$ 74,805	$ 46,552
Short-term investments	—	8,546
Restricted cash	1,129	1,098
Accounts receivable, net of allowance for doubtful accounts of $1,014 and $240 at September 30, 2001 and 2002, respectively	1,601	2,729
Inventories	607	1,956
Prepaid expenses and other current assets	857	1,065
Due from contract manufacturer	380	—
Total current assets	79,379	61,946
Property and equipment, net	3,454	2,236
Other assets	171	28
Total assets	$ 83,004	$ 64,210
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,279	$ 1,474
Due to contract manufacturer	3,117	—
Accrued compensation and other related benefits	883	683
Other accrued expenses	1,706	785
Accrued restructuring and other charges	1,368	355
Deferred revenue	93	23
Current portion of capital lease obligations and notes payable	60	14
Total current liabilities	8,506	3,334
Capital lease obligations and notes payable, net of current portion	9	—
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Preferred stock, $.01 par value, 5,000,000 authorized, and no shares issued and outstanding	—	—
Common stock, $.01 par value, 100,000,000 shares authorized; 35,188,095 and 35,679,075 shares issued; 34,887,195 and 30,780,972 shares outstanding at September 30, 2001 and 2002, respectively	352	357
Additional paid-in capital	175,288	174,252
Accumulated deficit	(93,438)	(107,563)
Notes receivable from stockholders	(702)	(281)
Deferred stock compensation	(6,813)	(1,185)
Treasury stock, at cost, 300,900 and 4,898,103 shares at September 30, 2001 and 2002, respectively	(198)	(4,707)
Accumulated other comprehensive income	—	3
Total stockholders' equity	74,489	60,876
Total liabilities and stockholders' equity	$ 83,004	$ 64,210

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents

NETWORK ENGINES, INC.

CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands, except per share data)

	Year ended September 30,		
	2000	2001	2002
Net product revenues	$ 38,216	$ 12,850	$ 14,534
Net license revenues	4,858	665	—
Total net revenues	43,074	13,515	14,534
Cost of product revenues (excluding stock compensation)	26,695	12,344	12,329
Cost of license revenues	34	5	—
Cost of revenues stock compensation	254	332	147
Inventory write–down	—	20,278	—
Total cost of revenues	26,983	32,959	12,476
Gross profit (loss)	16,091	(19,444)	2,058
Operating expenses:			
Research and development (excluding stock compensation of $430, $3,392 and $3,542 for the years ended September 30, 2000, 2001 and 2002, respectively)	8,219	12,704	4,693
Selling and marketing (excluding stock compensation of $1,217, $1,244 and $65 for the years ended September 30, 2000, 2001 and 2002, respectively)	15,760	18,118	3,836
General and administrative (excluding stock compensation of $1,020, $1,164 and $684 for the years ended September 30, 2000, 2001 and 2002, respectively)	3,963	7,047	4,602
Stock compensation	2,667	5,800	4,291
Restructuring and other charges	—	10,886	353
Amortization of intangible assets	—	675	—
Total operating expenses	30,609	55,230	17,775
Loss from operations	(14,518)	(74,674)	(15,717)
Interest income	2,197	5,175	1,596
Interest expense and other	(160)	(24)	(4)
Net loss	(12,481)	(69,523)	(14,125)
Accretion of redeemable convertible preferred stock	(8,103)	—	—
Net loss attributable to common stockholders	$ (20,584)	$ (69,523)	$ (14,125)
Net loss per common share—basic and diluted	$ (1.99)	$ (2.03)	$ (0.44)
Shares used in computing basic and diluted net loss per common share	10,344	34,241	32,270

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents

NETWORK ENGINES, INC.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (DEFICIT)

(in thousands, except share data)

	Shares of Common Stock										
	Issued	In Treasury	Common Stock Issued	Additional Paid–in Capital	Accumulated Deficit	Notes Receivable from Stockholders	Deferred Stock Compensation	Treasury Stock	Accumulated other Comprehensive Income	Total Stockholders' Equity (Deficit)	Comprehensive Loss
Balance, September 30, 1999	3,429,862	—	$ 34	$ 2,942	$ (11,434)	$ —	$ (1,439)	$ —	$ —	$ (9,897)	
Issuance of restricted common stock	650,000		6	221		(90)				137	
Issuance costs associated with Series D redeemable convertible preferred stock				(82)						(82)	
Issuance of common stock upon initial public offering, net of issuance costs	7,475,000		75	116,809						116,884	
Conversion of redeemable convertible preferred stock to common stock in connection with the initial public offering	21,448,442		214	45,606						45,820	
Issuance of common stock upon stock option exercises	650,577		7	66						73	
Issuance of common stock upon warrant exercises	564,704		6	202						208	
Interest on note receivable from stockholder						(4)				(4)	
Deferred stock compensation related to grants of stock options				13,916			(13,916)			—	
Amortization of deferred stock compensation to expense							2,921			2,921	
Cancellation of stock options upon employee terminations				(263)			263			—	
Accretion of redeemable convertible preferred stock to redemption value				(8,103)						(8,103)	
Net loss					(12,481)					(12,481)	$ (12,481)
Balance, September 30, 2000	34,218,585	—	342	171,314	(23,915)	(94)	(12,171)	—	—	135,476	
Issuance of common stock upon stock option exercises	243,624		2	59						61	
Issuance of common stock upon warrant exercises	159,065		2	23						25	
Issuance of common stock under employee stock purchase plan	116,372		1	396						397	
Issuance of common stock under merger agreement	450,449		5	8,887			(6,351)			2,541	
Purchase of treasury stock		(300,900)						(198)		(198)	
Issuance of stockholder notes receivable						(584)				(584)	
Interest on notes receivable from stockholders						(24)				(24)	
Amortization of deferred stock compensation to expense							6,132			6,132	
Stock compensation related to common stock option modifications				186						186	

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents

NETWORK ENGINES, INC.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (DEFICIT)—(Continued)

(in thousands, except share data)

	Shares of Common Stock										
	Issued	In Treasury	Common Stock Issued	Additional Paid–in Capital	Accumulated Deficit	Notes Receivable from Stockholders	Deferred Stock Compensation	Treasury Stock	Accumulated other Comprehensive Income	Total Stockholders' Equity (Deficit)	Comprehensive Loss
Cancellation of stock options upon employee terminations				(5,577)			5,577			—	
Net loss					(69,523)					(69,523)	$ (69,523)
Balance, September 30, 2001	35,188,095	(300,900)	352	175,288	(93,438)	(702)	(6,813)	(198)	—	74,489	
Issuance of common stock upon stock option exercises for cash	294,830		3	65						68	
Issuance of common stock upon cashless stock option exercises	119,469	(23,159)	1	23				(24)		—	
Issuance of common stock under employee stock purchase plan	76,681		1	66		p				67	
Purchase of treasury stock		(3,984,695)						(4,074)		(4,074)	
Collection of notes receivable from stockholders						45				45	
Repurchase of common stock through cancellation of notes receivable		(589,349)				411		(411)		—	
Interest on notes receivable from stockholders						(35)				(35)	
Amortization of deferred stock compensation to expense							4,438			4,438	
Cancellation of stock options upon employee terminations				(1,190)			1,190			—	
Unrealized gain on short–term investments									3	3	$ 3
Net loss					(14,125)					(14,125)	(14,125)
Comprehensive loss											$ (14,122)
Balance, September 30, 2002	35,679,075	(4,898,103)	$ 357	$ 174,252	$ (107,563)	$ (281)	(1,185)	$ (4,707)	$ 3	$ 60,876	

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents

NETWORK ENGINES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Year Ended September 30,		
	2000	**2001**	**2002**
Cash flows from operating activities:			
Net loss	$ (12,481)	$ (69,523)	$ (14,125)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	1,353	3,722	1,536
Provision for inventory reserve, net	1,036	20,278	—
Provision for doubtful accounts	176	755	29
Stock compensation	2,921	6,132	4,438
Interest on notes receivable from stockholders	(4)	(24)	(35)
Accrued income on short-term investments	—	—	(43)
Non-cash portion of restructuring and other charges	100	7,088	—
Changes in operating assets and liabilities, net of effects of acquisition in 2001:			
Accounts receivable	(9,956)	9,449	(1,157)
Inventories	(6,385)	(14,285)	(1,349)
Prepaid expenses and other current assets	(809)	(923)	(208)
Due from contract manufacturer	(7,113)	6,733	380
Accounts payable	4,552	(5,831)	195
Due to contract manufacturer	—	3,117	(3,117)
Accrued expenses	2,236	1,101	(2,134)
Deferred revenue	722	(734)	(70)
Net cash used in operating activities	(23,652)	(32,945)	(15,660)
Cash flows from investing activities:			
Purchases of property and equipment	(7,720)	(3,102)	(318)
Purchases of short-term investments	—	—	(8,500)
Changes in restricted cash	53	(1,082)	31
Changes in other assets	(136)	(35)	143
Acquisition of business including acquisition expenses	—	(30)	—
Net cash used in investing activities	(7,803)	(4,249)	(8,644)
Cash flows from financing activities:			
Proceeds from bridge loans and notes payable	2,205	—	—
Payments on capital lease obligations and notes payable	(2,273)	(84)	(55)
Issuance of notes to stockholders	—	(584)	—
Collection of notes receivable from stockholders	—	—	45
Proceeds from issuance of common stock	117,302	483	135
Acquisition of treasury stock	—	(198)	(4,074)
Proceeds from issuance of redeemable convertible preferred stock, net of issuance costs	25,168	—	—
Net cash provided by (used in) financing activities	142,402	(383)	(3,949)
Net increase (decrease) in cash and cash equivalents	110,947	(37,577)	(28,253)
Cash and cash equivalents, beginning of year	1,435	112,382	74,805
Cash and cash equivalents, end of year	$ 112,382	$ 74,805	$ 46,552
Supplemental cash flow information:			
Interest paid	$ 55	$ 24	$ 4
Non-cash investing and financing transactions:			
Restricted common stock issued in exchange for note receivable from stockholder	$ 90	$ —	$ —
Redeemable convertible preferred stock converted to common stock	$ 45,820	$ —	$ —
Repurchase of common stock through cancellation of notes receivable from stockholders	$ —	$ —	$ 411
Issuance of common stock in connection with cashless stock option exercises	$ —	$ —	$ 24

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents

NETWORK ENGINES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF BUSINESS

Business

Network Engines, Inc. ("Network Engines" or the "Company") is a provider of server appliance hardware and custom integration services. Server appliances are pre–configured computer network infrastructure devices designed to deliver specific application functionality. Since the Company's July 2001 restructuring, the Company is focused on partnering with independent software vendors ("ISVs") and original equipment manufacturers ("OEMs") to provide these strategic partners with server appliance hardware, integration services and appliance development, deployment, installation and support to allow these strategic partners to deliver "turn–key" solutions to their end–user customers. To date, the Company's customers have been primarily located in the United States. The Company operates in one reportable segment.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated. Certain amounts in the prior years' financial statement have been reclassified to conform to current year presentation. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period. The most significant estimates reflected in these financial statements include accounts receivable and sales allowances, inventory valuation and warranty reserves. Actual results could differ from those estimates.

Cash, Cash Equivalents, Short–term Investments and Restricted Cash

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents; all securities purchased with an original maturity of greater than three months and that mature within 12 months from the balance sheet date are considered short–term investments. All investments are classified as available for sale and are carried at fair value, with unrealized gains and losses included in other comprehensive income or loss, which is a separate component of stockholders' equity, until realized. The Company recognizes realized gains and losses on a specific identification basis. The Company invests excess cash primarily in municipal bonds, money market funds and government agency securities.

At September 30, 2001 and 2002, $77,000 and $46,000 of cash was restricted and pledged as collateral on the Company's facilities, respectively. Additionally, at September 30, 2001 and 2002, approximately $1,052,000 was restricted and deposited with a financial institution as a guarantee for a personal loan of the Company's Chairman (see Note 7).